RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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April 23, 1986 LETTER 937

**THE MARKET:** What do the old timers say? Oh yeah, "you can't stop a freight train, but if you've got any brains, you'll at least get off the tracks." That's been good advice for market doubters, pessimists, cynics and outright bears over the last few years.

You sure get that freight train feeling as you watch the stock and bond markets roll their way higher. You see the thin yields, you see many stocks that have doubled and tripled, you see the long government bond yields down around 7%, you see the major averages and indices up on "stilts." All of these are enough to give the market veteran a case of white knuckles. Then, in the face of sluggish retail sales, in the face of a bumbling Congress, in the face of the US attack on Libya, the market pushes to new highs. And the only intelligent thing to do is be on the train or at least get off the tracks.

The bullish progression is, to say the least, impressive. On April 14, the heretofore lagging AMEX and NASDAQ indices hit new record highs. On the same day, my Primary Trend Index recorded a new record high. Then on April 16, we witnessed new record highs in the D-J Industrial Average, the NYSE Composite, the NYSE Industrials, Utilities and Finance indices, plus new record highs in the S&P 500 and the S&P 400 Industrials, Utilities and the S&P 100.

I wrote in the last Letter that the third "buying stampede" had ended, but no sooner had the A-D ratio dropped the required distance to signify the end to the stampede than it turned up again. On April 16, the A-D rallied to a new bull market high. Could this be the start of (an amazing) fourth buying stampede? Time will tell, but remember, the A-D ratio has to rise an uninterrupted five points to define a buying stampede, and another five points here would be extraordinary.

Are there any negatives in the current market picture? Of course, there always are. From a Dow Theory standpoint, the Transports have not yet confirmed the new Dow highs, and it will take a rise above the March 31 high of 830.84 to signal an all-clear on the part of the Transports. Well, I'll go into the worrywart picture in the next section.

**MARKET THOUGHTS:** A few of us old timers are just a teeny bit worried about this bull market. I guess (and it's an old habit) that when everyone and his brother agrees on something (in this case, that the market ultimately must go higher) I get nervous. After all, the first phase of the amazing 1984-86 "buying stampede" began on Dec. 13, 1984, and since then, except for minor interruptions, the market has been stampeding upwards.

The rise from the December 1984 low to the recent highs has advanced the A-D a whopping 19 points.

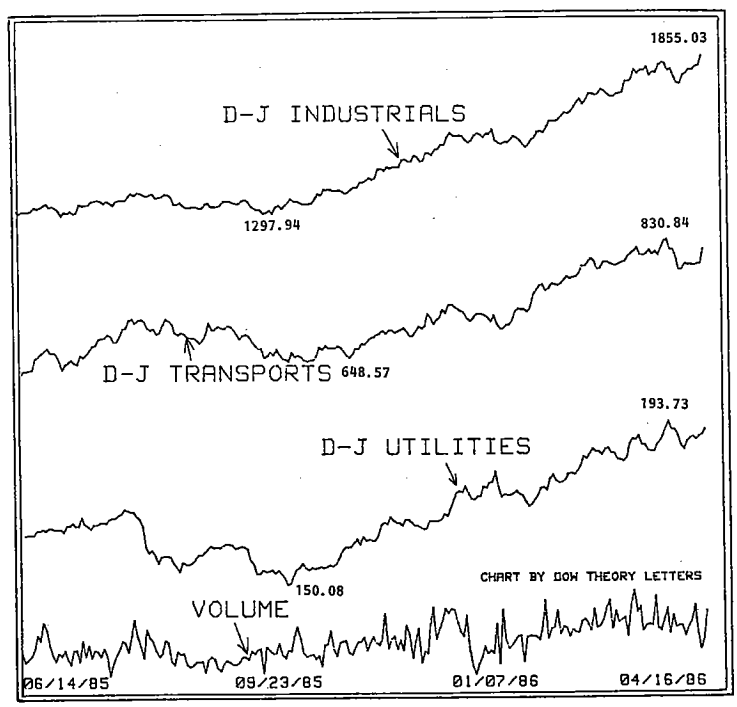
April 11 DJIA 1790.18; PTI 2238; A-D Ratio -5.79
April 18 DJIA 1840.40; PTI 2264; A-D Ratio -4.95

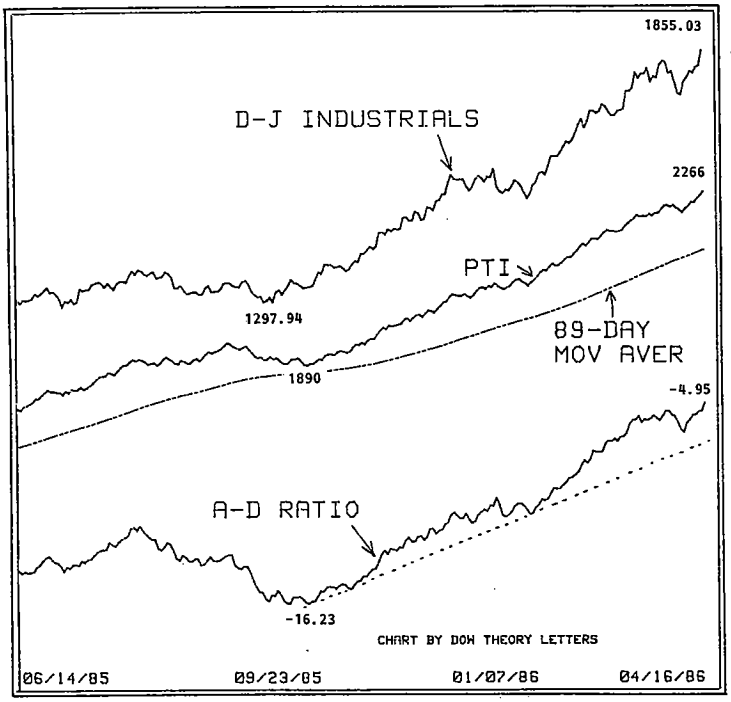
There haven't been many rises like that in recent history, so it is only natural for nervous types like me to fret when we see the market up on stilts (actually most of today's stock market participants have never seen anything like a 19-point rise in the A-D ratio).

It might be interesting to compare the 1984-86 advance with some of the big A-D advances of the past. As against the 19-point rise of '84-'86, the big bull rise of 1982-83 advanced the A-D ratio 16 points (and that, of course, was no slouch rise either). Going back a dozen years, the explosive rise off the 1974 bear market bottom took the A-D ratio up 12 points -- to a 1975 peak.

To see anything comparable to 1984-86, we have to go back to 1957-58. Starting from the December 1957 low, the A-D ratio rose 19 points to a 1959 high. Prior to that, another great breadth move occurred during 1953-55, a period which saw the A-D ratio rise an astounding 27 points without a major correction.

The question may be asked, "Russell, why are you using comparisons of the A-D ratio instead of comparisons with the Dow or some other average?" And the answer is that the A-D ratio traces the advancing or declining activities of ALL stocks on the NYSE. Furthermore, the adjustment (i.e., dividing the daily advance-decline plurality by the number of issues traded) allows valid comparison at any time in history. A 10-point rise in the A-D ratio today is just as impressive as a 10-point rise in the ratio back in 1943.






The point I am making is that the 19-point gain in the A-D ratio in the 1984-86 period is a modern-day whopper. It's meaningful, and it's telling us something. You just don't get 19-point rises in the A-D ratio for no reason at all.Such rises aren't mere upward corrections and they aren't mistakes. They come as a result of HUGE amounts of money entering the market and entering on a persistent and continuous basis. In the past, rises of 15 to 20 points in the A-D ratio have been followed by major improvements in either (or all) the following: political, social, economic well-being of the nation. In other words, a 15- to 20-point rise in the A-D ratio indicates that the investors' perceptions of the background for securities has CHANGED for the better.

The obvious changes are clear enough today. Oil prices have caved in. Inflation has moved to the zero level. Interest rates have been halved. The nation has abandoned the namby-pamby, turn-the-other-cheek posture of the Jimmy Carter years. The US is (at last) addressing the deficit issue. Finally, the dollar has declined substantially from its recent ridiculous highs.

But it seems to me that the great breadth rise of 1984-86 is pointing to something more for America. I can only guess as to what that "more" might be, and your guess will be as good as mine. But I think it's going to be good.

In the next section, I examine some of the psychological and value measurements now worrying investors. So far, the price action and the breadth action of the stock market have been good. Market sentiment? Market values? Let's talk about them.

**HOT?** With new record highs in the AMEX and NASDAQ and the yield on the Dow down to 3.6%, some observers are hinting that maybe this market is (1) becoming a bit over-heated, and (2) maybe this market is becoming over-valued. It's difficult to measure bull market heat (i.e., speculative intensity), which is why Robert Rhea, the great Dow Theorist of the 1930s, often asked, "How hot is hot?"

And, of course, there is no absolute answer to that question. The market looked very hot all during 1928 and early '29, but the top didn't come until September 1929. The market looked hot again in 1936, but it wasn't until April 1937 that the peak finally arrived. True, the 1937 top was a bit tamer than the '29 top -- mainly because many investors and speculators still had 1929 fresh in their minds.

The year 1965 was frenzied and frothy, and I personally turned bearish in late-1965. By January 1966, it was all over, and the bear had a feast on Wall Street for a while. The next sizzling market occurred during '68 and again during the early '70s. I got the chills during 1972, and the years 1973 and '74 justified my fears as Wall Street suffered its most blood-curdling bear market since 1937.

Now we're moving back into hot territory again, and everyone is wondering whether "this is it" and whether it's time to take the money and run. My answer is "yes, this is definitely a hot market, a speculative market, but I don't know how hot it might get." You know, a primary movement (in this case a bull movement) is a law unto itself, and the things a bull market is capable of doing, well, you (and I) just wouldn't believe it -- until it happens.

I follow dozens of indicators, and most of them confirm that this is a speculative market. Yet, a bull market can STAY exciting for weeks and months. A bull market can take the standard measurement to extremes, then greater extremes, and finally to crazy extremes. And who's to say that we're not heading for crazy times now -- certainly not I.

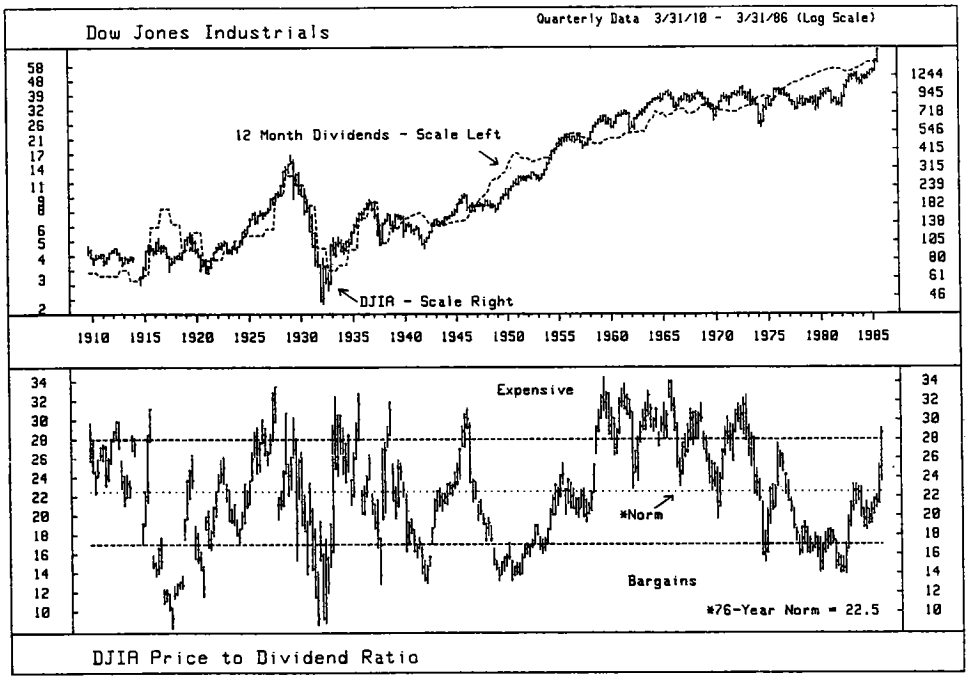
As I stated at the beginning of this section, we can look for over-heating, and we can look for over-valuation in a bull market. Up to now, I've been talking about over-heating and how hard it is to measure the heat.

Valuation is a much more objective and much easier thing to measure. Charles H. Dow placed great emphasis on values, and he wrote that stocks were expensive (and usually under distribution) when the dividend yield on blue-chip issues dropped to 3.5% or less. That was Dow's cut-off point or danger signal.

Historically, the yield measurement has been more accurate than price-earnings ratios, and this is because dividends are a more reliable measurement than earnings (earnings, as someone once said, are a matter of what your accountant says they are).

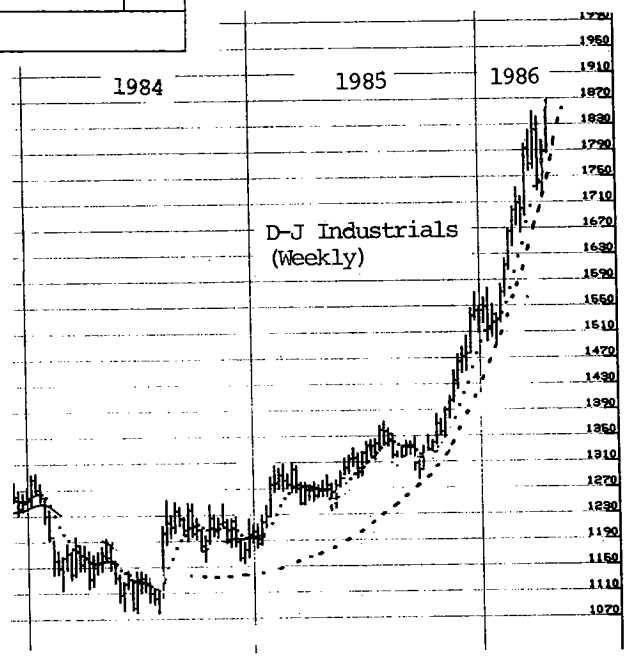
At any rate, the current yield on the Dow Industrials is 3.6%. That's low, but I have seen it lower. Another way of expressing the yield is in terms of price-to-dividend ratio, or simply what multiple the Dow is of its dividends.

This Ned Davis Research chart (page 3) provides an excellent historical perspective of where we are now in terms of Dow dividend multiples. As you can see, the norm going back to 1910 is for the Dow to sell at 22.5 times its dividends. When the Dow gets down to 12 to 15 times dividends it's a bargain. When the Dow gets up to 28 or more times dividends, it's expensive. We're in the high area now. In other words, Dow dividends are now expensive.


Dow Jones Industrials
Quarterly Data 3/31/10 - 3/31/86 (Log Scale)
12 Month Dividends - Scale Left
DJIA - Scale Right
1910 1915 1920 1925 1930 1935 1940 1945 1950 1955 1960 1965 1970 1975 1980 1985
Expensive
*Norm
Bargains
*76-Year Norm = 22.5
DJIA Price to Dividend Ratio

The accompanying weekly chart traces the path of the Dow over the past three years. One thing that bothers me is that the move has now assumed the form of a parabolic rise. Furthermore, the 1986 portion of the rise has gone almost vertical.

Now no one can say whether the vertical portion of the parabola will end at 1830 or 1850 or 1950. But the formation seen on this futures chart is that of a parabola, and that worries me a bit. The correction, when it comes, could be rougher than most of today's bullish analysts are expecting.




You can pick the great over-valued tops and bargain bottoms on this chart as easily as I can, and the remarkable thing is how well this simple valuation test has worked over the years. From the standpoint of this chart, the best thing that could happen now is that the Dow would rest, business would get better and corporations would raise their dividends -- thus giving this bull market more time. The worst thing that could happen is more of what we've been seeing so far here in 1986. In other words, if the Dow was simply to continue spiking up, then before 1986 was over we'd see the dividend multiple in the 32 to 34 area, and it would be "run for the hills time." That's the story and you can argue with history about it. Personally, I'd like to see the market slip into a trading range for a while, but as I've so often said -- they don't make the market to suit Richard Russell.

In this business, I find that the fewer decisions the market forces one to make, the better your record. So if it's all the same to the gods of Wall Street, how about giving me a nice sideways sort of trading range. Nothing big on the downside, just a trading range of say 1750 to 1850. Thanks.

I have talked about over-heating, and I have talked about over-valuation. Now I want to discuss one more item. And that is the rising parabolic curve. The parabolic curve or exponential rise occurs when an item (any item) starts up, accelerates its climb and finally enters a straight-up or vertical rise. The final (vertical) stage of the parabola is exciting, usually breathtaking, but in the end, it is unsustainable. So the aftermath of a parabolic curve can be very damaging, very costly.

One unfortunate characteristic of the parabolic curve is that it tends to use up all the upward energy as it progresses. In other words, by the time the parabola has ended its vertical rise, all the bull energy is expended. Thus, many vicious collapses have followed the peak of parabolic rises. The most recent example of this was the gold collapse which followed the parabolic rise of 1977-80.

**INVESTMENT POSITION:** What are the two hardest things to do in the markets? (1) Stay out of a bear market (it will do everything in its power to lure you in). (2) Stay with a bull market (it will try a thousand tricks to try to get you out).

We're in a bull market, and I've tried to get that across in the simplest way I know how -- by keeping this picture of the bull in the box. The bull has been nervous at times. I've drawn him shaking at times, but he's stayed persistently in the box where he belongs. And I trust the stocks and bonds have also stayed in my subscribers' portfolios. You can't make money in a bull market unless you hold the goods. That's the real bull market secret, and I hope you've all been adhering to the secret formula.

Over the last year I've stated that by definition the Dow must go up in a bull market -- so why not hold the strongest Dow stocks? That method has worked

and worked well. Currently, the strongest Dow stocks are AXP, DD, MC, MRK, OI, MO, S, WX, Z. It's probably late to start buying. If you haven't purchased your wares by now I guess I don't know what to tell you. If you're going to add, choose from the above list. I'm finished buying, and I'm going to sit tight for a while. No, I'm not selling, just sitting. That isn't a bad policy for the time being.

**CONFESSIONS OF A STODGY INVESTOR:** Is there an intelligent way to make big money in the markets? I know lots of ways to (try to) make big money in the markets. Here are a few: (1) You take a big position in one or a few stocks that you have researched carefully -- and then you watch those stocks like a hawk. (2) You trade stocks based on some particular approach you are familiar with. (3) You trade commodities. (4) You compound the income from safe, dividend-producing securities. (5) You follow some stock market genius who is a good friend and who also is kind enough to tell you what he's doing. (6) You buy a lot of stock in some hot company that you happen to be employed by -- and you stay close to the company treasurer.

Confession: Only No. 4 appeals to me, and this is a procedure which I use. The rest of these items may work for you -- they've never worked for me, although I suppose I would have used No. 6 if I had worked for some great growth company.

But being on my own, I operate on the basis of values. I reason as follows: I can only make big money if a situation arises in which I have enough faith so that I can invest a large chunk of capital. I can't make big money buying 100 shares of this or that -- I've got to go in big. And that means that the market must be inviting from a timing standpoint and the values must be there.

I've only invested in a big way three times since I started in this business. The first time was early 1958. The stock market had caved in during 1957, everyone was dead bearish, and good stocks were selling at mouth-watering yields. I started this business in 1958, and at the same time I put every dollar I had in the stock market. I felt extremely confident of that market and I even went heavily on margin. The stock market took off on a "breadth stampede" that took the A-D ratio up an amazing 19 points by early-1959. I did very well on that one. By early 1959, I was in "happy shock."

Next case, and it occurred 15 years later. During late-1973 and during most of '74, the market experienced a crushing bear market. Stocks collapsed, the A-D ratio was shattered, and good shares were selling for give-away prices. I bought heavily in late-1974 and early 1975 (and, by the way, urged my subscribers to do the same). The market has never seen those 1974 lows again. The advance up from the '74 lows was spectacular and anyone who bought anything during late-1974 had to make money. It was almost impossible to lose.

During the last few years I felt that the bond market was a steal. I wrote Letter after Letter about the value of compounding high-yielding bonds. I ran compounding charts for my subscribers. I showed how money could double at various rates of interest in relatively short periods of time. I reasoned that at tax-free yields of 10%, you would get better than a third of your money back in three years, and that this kind of mathematics indicated that muni bonds or T-bonds at 12% and more were a great bargain. Happily, on this latest tirade of mine, many subscribers got the message. They loaded up with bonds. The income came in and the bonds went up, up, up.

So much for history, but what can we learn from it all? In all three cases I had (1) timing on my side, and (2) values on my side. Those two items gave me the courage to go in with a big chunk of my own capital (in 1958 I went in with all my capital, but I'm getting too old and stodgy to do that now).

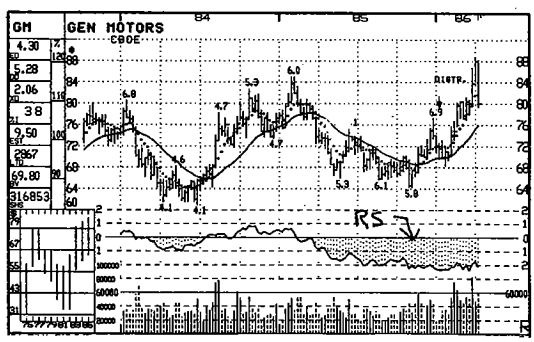
But the point I wanted to make has been made. And it's this. Maybe once in five or 10 years you get a situation such as we have seen recently in bonds when the securities represent great values, when the items are down and out, and when no one wants them. Government bonds paying 12% and 13%, muni bonds paying 10% and 11%! And you couldn't give 'em away during the early 1980s. That's the time I'll load up and take my stand.

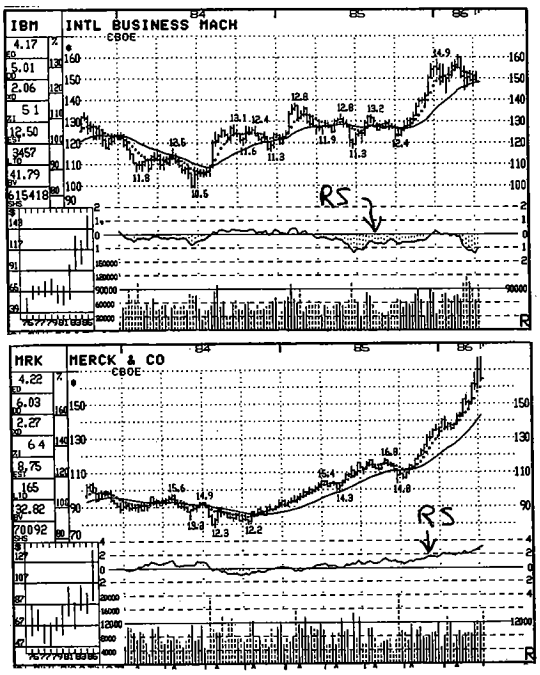
When will we see the next bargain period, a period when everything seems to militate in favor of the buyer (even though the public hates the item)? I don't know, but as sure as night follows day, that time will come again. We'll probably see another great bargain time before the 1980s are out.

Right now the only items that "seem" dirt cheap to me are commodities, but I don't buy commodities for one reason. Unlike stocks or bonds, nobody pays me to sit with wheat or bellies or copper. A great bargain investment pays you while you wait -- the way stocks did in 1958 and 1974-75 or the way bonds did during the early 1980s. Remember, if it's an investment it pays a return. If it doesn't pay a return, it's a speculation, and I personally almost never speculate. Heck, I've yet to even buy a California lottery ticket (the tickets don't pay a return, and, moreover, I don't like the odds).

**THREE STOCKS:** Many neophytes don't understand the concept of relative strength and what it can tell you. For instance, study the charts of these two reputed stock market bellwethers, GM and IBM. In both cases, their relative strength (RS) has been sub-standard, which means that these two stocks have not kept up with the general market. GM's RS has been deteriorating for months. And although the stock has rallied well over the last six months it is still below its price of early 1985. IBM has shown doubtful RS during most of 1985 and '86, and during '86 the stock has gone nowhere.

So it has remained for other Dow stocks to raise the DJIA. One of the real winners has been Merck. This Dow stock has been sensational ever since mid-1984. And the RS line provided the hints. It's been up






and up for MRK's RS line. For other strong Dow RS stocks, see Investment Position box. (Charts courtesy of Mansfield.)

**MUNIS TAXABLE?** Fears by investors that muni bonds would be subject to taxes have rendered the muni market a bargain in comparison with other bonds. With long-term government bonds yielding roughly 7.6%, it is incredible that one can buy AA-rated muni bonds at the same rates or better! So the question is, will muni bonds be taxed?

My answer is no. The fear started when a 1983 amendment to the Social Security law stated that you must include your muni income when figuring your total income for SS purposes. If an individual's total income is above $25,000 ($32,000 for a couple), then part of the SS receipts will be taxed. This abomination is now being challenged in a number of court cases backed by the firm of Lebenthal (Mr. Lebenthal is one tough, articulate guy). Personally, I don't think the courts will uphold this amendment.

Next came various ideas from Congress to indirectly tax muni income through the mechanism of an alternative minimum tax. Here again, muni income would be considered as part of gross income. Reciprocal immunity (state immunity from federal taxes and federal immunity from state taxes) has always been upheld by the Supreme Court. In my opinion, any attempt to indirectly tax muni income through an alternative minimum tax will be ruled unconstitutional, and certainly unconstitutional on presently existing muni bonds. If the new concept were by some hook or crook to become law for newly issued munis, these munis would sell at a huge discount and therefore would hardly be worth issuing.

I think investors are beginning to sense the unconstitutionality of a new muni tax law. As this perception becomes widespread, it will also be perceived that compared with other bonds, munis are now a bargain.

On April 16 the T-bond futures contract broke out to new highs. The muni bond contract, which never broke below its major trendline, surged up in sympathy with T-bonds.

**NOTES & QUOTES:** The great 1986 tax changes (I refuse to term them reforms) look increasingly doubtful. The Congress doesn't know what it's doing, and the public sees nothing to be gained. I have been a cynic on real tax reform all along, and for one reason -- real tax reform would put the massive "tax industry" out of business. The IRS budget (cost) alone is $3.8 billion. Add to that the expense of accountants, lawyers, tax preparers, tax courts, tax lobbyists, etc., and you've got an entrenched empire that sees true, simplified tax reform as a menace to its existence. On top of that Congressmen view tax breaks as a form of political pay-off, and giving up power is the last thing on God's green earth that lawmakers want to do.

About a million words a week are pumped out by the tax industry on tax cases, changes, interpretations, etc. It's a national disgrace, and it's eating into America's productivity. If I had my way, I'd have a simple 20% tax on everybody across the board (poverty cases excepted) and no exemptions at all -- none. That would put the tax industry out of business, and bring in more money than the current abominable system. But I'm asking the tax industry to give up power and turn to productive work. That will only occur in a national crisis.

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I've been saying for years that the biggest bargain in the stores these days is food! And this is particularly true if you're a vegetarian. A good wholesome dinner of assorted vegetables, bread and fruit costs you around $1.50. Compare that with the current cost of a car, a home or tuition at a top college. Food is today's super bargain!

**WASHINGTON (AP) — The farmer's share of each dollar spent by consumers for food last year dropped to 31 cents, snapping a 52-year record low mark, according to new figures by the Agriculture Department.**

**The department's Economic Research Service said in an annual report that overall the low farm value was "the primary reason that retail food prices rose less than prices of other consumer items" in 1985.**

**Until last year's 31 cents, the previous record low share of the consumer food dollar was 32 cents in 1932 and 1933, in the depths of the Depression, according to USDA records.**

* *

Cynic: The other day I felt cynical, and I started thinking of the truly great growth industries in America. They are (1) death, (2) taxes, (3) debt, (4) waste production or garbage, and (5) corruption. All right, how can you participate in these guaranteed growth industries? (1) For death, buy Hillenbrand Industries, a leading manufacturer of coffins, and an excellent stock as well. (2) For taxes, buy a big defense stock like General Dynamic, recipient of a hell of a lot of our taxes. (3) Debt: Buy some T-bonds and at least OWN some of the US debt. (4) Waste (and boy is this a growth industry), buy Waste Management or Browning Ferris, both fine growth stocks. (5) Corruption: this is a tough one, but I guess Circus Circus and Bally are at least close to it, both of them deriving income from gambling.

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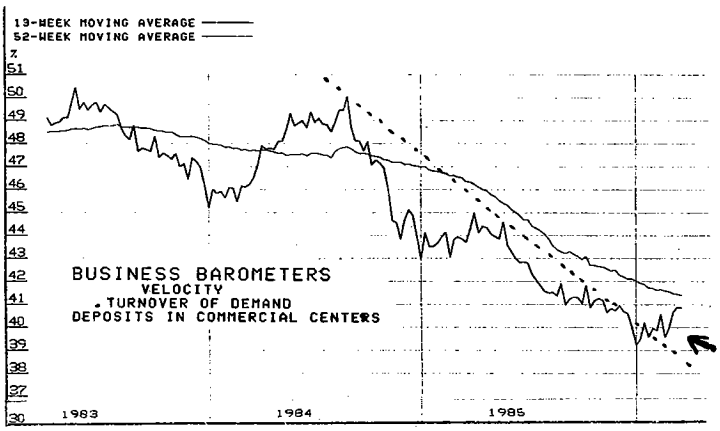
Forget all the nonsense you read about whether the economy is going to falter, turn up or boom. It's all in this chart showing the turnover of deposits in the leading commercial centers. In other words,

"velocity" shows you how much action is going on in the checking accounts at the banks.

Note that from August 1984 until December 1985 the trend of velocity was down. The Fed obviously was aware of this, and that's one reason why they allowed the money supply to boom. But since January 1986, velocity has been climbing (although gingerly). Nevertheless, if the TREND of velocity is now up and it stays up we are going to see an improving if not booming economy. The story is all in this chart, and I will keep you up to date (chart from Mansfield).

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Oil: From all my reading, here is the informed opinion on how leading oil stocks will do if the price of crude stays low (say below $18 a barrel). In the best shape are Royal Dutch, Exxon and Amoco. Fair shape are Chevron, Standard Oil, British Petroleum, Mobil, Arco. In poorest shape with dividend cuts possible: Texaco, Unocal and Phillips Petroleum.

* *

Asia: I keep talking about the coming major competition from non-Japanese Asia (the Japanese competition is bad enough). This piece is from an article in last week's NY Times. I thought it made interesting reading.

Special to The New York Times

INCHON, South Korea — In a factory the size of an airplane hangar, beyond lines of workers bending over huge machines, stands a solitary assembly line with no workers — operated by a room full of computers that program the manufacture of engine cylinder blocks. It is the Daewoo Corporation's first fully automated assembly line, part of its effort to keep manufacturing costs low.

Assembly lines are still the exception at Daewoo and for most Korean companies, whose ability to turn out lower-priced cars, lower-priced steel and lower-priced video cassette recorders is mounting an increasingly tough challenge to the United States and Japan. The key to Korea's success as a low-cost producer is not the automation or inventory controls that distinguish Japanese manufacturing, but lower wages and a highly disciplined and productive work force, according to analysts.

Both South Koreans and Americans, when pressed to explain why a company like Hyundai can produce a high-quality subcompact car and sell it for less than $5,000 in the United States, point above all to a labor force schooled since childhood to be obedient and bound by economic necessity to work long and hard.

* *

Newhard, Cook & Co of St. Louis adjusted all 30 Dow stocks for inflation and found only three winners for the January 1966 to November 1985 period. They were Amer. Express, up 250%, Merck, up 3% (although Merck has been sensational over the past six months), and McDonalds, up 950%. Thus MCD has been the all-out star of the Dow (too bad it is such a recent addition to the Dow). In comparison to MCD, IBM is down 16% on an inflation-adjusted basis.

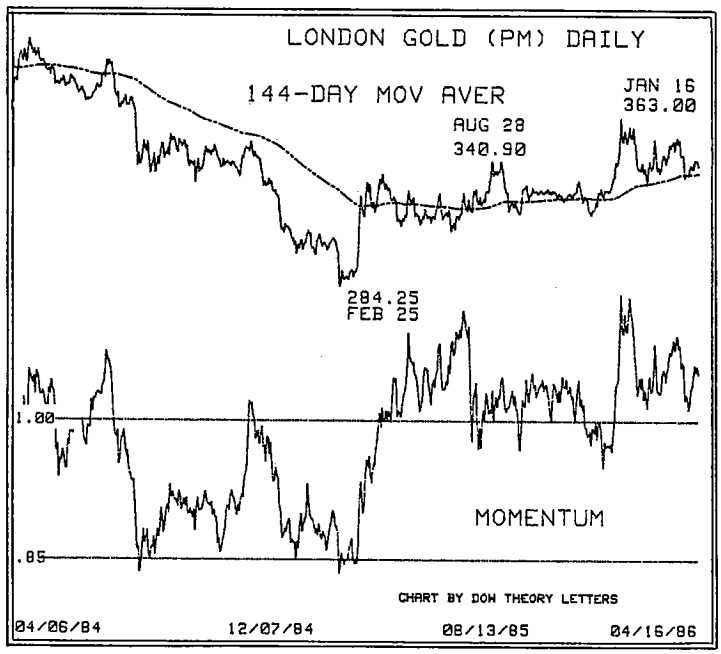
GOLD: Gold is a mystery. The mystery is what's holding it up? Crude oil is near its lows, the commodities are a disaster area, US inflation has plunged toward the zero level, and the rest of the metals (except platinum) show nothing.

Technically, the gold picture is now a mixed bag. The background ratios for gold are negative. The gold-common stock ratio is at a six-year low (which means that gold's relative strength compared with stocks is at a multi-year low). The gold-bond ratio is also at a major new low, and this points to a deflationary atmosphere.

With it all, gold on my chart is still hanging on to the positive side of the ledger. As you can see, gold is still slightly above its rising 144-day moving average. And at the same time, the momentum (89-day rate-of-change) is still bullish.

On my point & figure chart it will take a London fix of 328 to set off a bearish signal. Should 328 be touched off, the next support comes in at 312.

As subscribers know, I have advocated only one approach to gold over the past year, and that is buying gold coins on a coin averaging basis monthly. This means buying a fixed number of coins each month, and I don't care whether it's one coin, 10 or 20. I have not recommended the gold shares themselves. And I won't until a gold bull market is clearly in place, and gold is moving up!




LATE NOTES: The buying stampede ended on April 4, but note that the A-D held well above its rising trendline (page 2 chart). Then on April 18, the A-D rallied to a new high. You have to be impressed!

April 18, the Fed cuts the discount to 6.5%, an eight-year low. At the same time, the dollar drops to new lows. As far as the stock market is concerned, it continues to go north easily, but south reluctantly. It is well to remember that as this market advances, it is subject to steady technical deterioration. For instance, the odd-lot public is growing more bullish and it is cutting back on its sales, stepping up its buying (a negative). Watch that 830.84 level on the D-J Transports -- it must be bettered for a Dow Theory "all clear" signal.

NEXT MAILING: May 7